

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
STANDARD OIL COMPANY OF CALIFORNIA)

Appearances:

For Appellants: Toni **Rembe** and
 Donald **E.** Bradley
 Attorneys at Law

For Respondent: Kendall E. Kinyon
 Counsel

O P I N I O N

This appeal is **made** pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Standard **Oil** Company of California against a proposed assessment of additional franchise tax in the amount of **\$4,867,453.93** for the income year 1967.

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Appellant is a Delaware corporation with its principal office in San Francisco. It is the parent company of an affiliated group of domestic and foreign subsidiary corporations engaged in all aspects of a worldwide unitary petroleum business. Certain aspects of appellant's unitary petroleum business, such as exploration and production, refining and marketing, and pipeline transportation are conducted not only by appellant and its controlled subsidiaries, but also through affiliated joint venture corporations in which appellant and its subsidiaries have a 50 percent or less participating interest.

For the appeal year appellant and its subsidiaries-doing business in California filed their franchise tax returns on the basis of a worldwide combined report. In accordance with section 25106.1 of the Revenue and Taxation Code, dividends received by appellant and its subsidiaries from other members of the unitary group were eliminated in the combined report computation. Dividends received by appellant and its domestic and foreign subsidiaries from noncontrolled affiliated joint venture corporations were reported as apportionable business income. Respondent determined that these latter dividends constituted nonbusiness income specifically allocable to each recipient's commercial domicile. The principal dividends involved are those from Arabian American Oil Company (Aramco) and P. T. Caltex Pacific Indonesia (CPI), affiliated joint venture oil producing companies which served as major sources of supply for appellant's worldwide activities relating to the acquisition and disposition of crude oil.

Appellant contends that the dividend income arose in the main course of its unitary petroleum business and was derived from intangibles acquired and managed as an integral part of that business: therefore, the dividends constitute business income in accordance with section 25120. In the alternative, appellant seeks relief under section 25137, arguing that specific allocation of the dividends in question would not fairly represent the extent of its activities in California.

1/ Unless otherwise indicated, all section references are to sections of the Revenue and Taxation Code.

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It is respondent's position that dividends received by a corporation commercially domiciled in California are specifically allocable to this state. Respondent also contends that appellant has not met its burden of proving **that** it is entitled to relief under section 25137.

The primary question presented by this appeal is whether the dividends received by appellant and its subsidiaries from noncontrolled affiliated joint venture corporations constitute business income subject to formula apportionment or nonbusiness income specifically allocable to each recipient's commercial domicile in California. If the dividends are determined to be non-business income, we must then consider whether appellant is entitled to the relief it seeks under section 25137.

Appellant is a wholly integrated oil company engaged in all aspects of the **petroleum** business throughout the world. During 1967 appellant, either directly/
or through its 200 domestic and foreign subsidiaries, engaged in the following business activities on a world-wide basis:

1. Exploring for, producing and refining crude oil and natural gas liquids into petroleum products;
2. Transporting, marketing and distributing crude oil, natural gas liquids **and petroleum** products; and
3. Manufacturing and selling industrial, agricultural and garden chemicals.

In addition to its many subsidiaries, appellant, in connection with its unitary petroleum business, held, directly or indirectly, a 50 percent or less **participating interest** in many affiliated joint venture corporations^{2/} which were engaged in various aspects of the petroleum business throughout the world.

2/ "Subsidiaries" refer to corporations in which appellant, directly or indirectly, held more than a 50 percent stock interest.

3/ "Affiliate," "affiliated corporation" or "affiliated Joint venture corporation" refers to a corporation in which appellant, directly or indirectly, held a 50 percent or less stock interest.

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In order to understand the role of the affiliated joint venture corporations in relation to appellant's worldwide petroleum business, it is helpful to consider the geographical organization and structure of the unitary business of appellant and **its** subsidiaries in 1967 and the development of the affiliated, joint venture corporations' relationship to that unitary business.

Appellant's North American operations **involved** all aspects of the exploration, production, transportation and distribution of crude oil **and** natural gas, the refining, manufacturing, transportation and marketing of petroleum products, as well as the manufacture and marketing of petrochemical and asphalt **products** throughout the United States and Canada. Crude oil necessary for United States and Canadian refining and marketing operations was supplied not only from appellant's **North** American producing locations, but also from producing fields in the Middle East, Far East and South America in which appellant or an affiliate held an interest. Other North American **affiliates** of appellant were 'also engaged in petroleum-related activities such as oil and gas pipeline distribution and the production and marketing of petroleum-derived products in the United States and Canada.

Appellant's Central and South American operations included exploration, production **and** refining activities in Venezuela and Colombia, and marketing activities in various parts of Central and South America. Appellant also marketed petrochemical products throughout Central and South America. In connection with these operations, affiliated corporations engaged in refining, and marketing activities in Peru.

In the Middle East, Africa, the Far East, and Australia, appellant's operations included the **exploration**, production, acquisition and disposition of crude oil. Appellant's operating interests in oil and gas fields were located in Libya, Nigeria, Indonesia, **Western** Australia and Iran. Additionally, in 1967 appellant owned 30 percent of the stock of Aramco, **which** held and operated major producing fields in Saudi Arabia, and 50 percent of the stock of CPI, which held and operated major producing fields in Indonesia. Appellant was entitled to a share of the oil and gas production of these two affiliates. Appellant also owned 50 percent of the stock of California **Texas Oil** Corporation (Caltex), which was engaged in petroleum operations in the Eastern Hemisphere. Caltex was a major customer of appellant and purchased a substantial quantity of crude oil from appellant's Middle Eastern and Far **E**astern fields.

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Appellant's Western European operations involved all aspects of the petroleum business. Appellant's crude oil transportation, refining and marketing operations in this area were acquired in May of 1967 as a result of the reorganization of Caltex's Western European operations. A number of appellant's affiliates were engaged in most aspects of the Western European integrated petroleum operations.

As an essential element of its international activities, appellant conducted a worldwide system of crude oil trading and marine transportation operations. The purpose of this system was to ensure that the worldwide supply of crude oil was properly allocated and distributed among its subsidiaries and affiliates throughout the world.

Although it was in 1905 when the United States oil industry first began to focus attention on the Eastern Hemisphere's potential for development, appellant did not direct its attention to this area until sometime later. It was during the early 1930's when appellant discovered oil on the island of Bahrain in the Persian Gulf, secured an exclusive concession from the ruler of Bahrain, and formed a subsidiary to hold and operate the concession. In 1933 appellant obtained a concession from the ruler of Saudi Arabia and formed a wholly owned subsidiary, California Arabian Standard Oil Company, the predecessor of Aramco, to operate the concession. In 1936 appellant acquired a concession from the Dutch government with respect to Sumatra and Java, and formed another wholly owned subsidiary, the predecessor to CPI, to hold and operate this contract.

Appellant's discovery of oil in Bahrain and the crude oil potential of Saudi Arabia and Sumatra created a need for the development of market outlets. At this time Texaco had a substantial marketing organization but no available crude oil in the Eastern Hemisphere. In order to obtain the essential market outlets, appellant transferred a one-half interest in the operating subsidiary which held its Bahrainian concession to Texaco for all of Texaco's Eastern Hemisphere marketing subsidiaries outside of Europe. In addition, Texaco acquired from appellant a 50 percent stock interest in Aramco and CPI in exchange for cash, deferred payments and an option to acquire a 50 percent interest in Texaco's European marketing subsidiaries. Because of World War II, however, this option was not exercised. As part of their agreements, appellant and Texaco agreed that the

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affiliates would be operated on a cost basis and that neither would dispose of their interest in the affiliates without first giving the other an option to purchase that interest. By 1946 **Aramco's** annual production of **60,000,000** barrels of crude oil was available to appellant and Texaco at Aramco's cost plus fixed per-barrel government royalty payments.

The vast oil reserves discovered in Saudi Arabia during the late 1940's generated the need for a pipeline from the eastern seaboard of Saudi Arabia across the Middle East to the Mediterranean. The anticipated cost of the pipeline led appellant and Texaco into negotiations with Exxon and Mobil. As a result, an agreement was reached whereby: (1) Exxon and Mobil acquired a 30 percent and 10 percent interest, respectively, in **Aramco**, thereby reducing appellant's and Texaco's respective interests to 30 percent; and (2) the four shareholders agreed to offtaking arrangements with respect to Aramco's production to insure that they had the right to purchase at an 18.3 percent discount from the offtaker's published price the entire export production of Aramco in order to satisfy their crude oil requirements. Aramco's earnings' under these arrangements, after setting aside funds required for capital expenditures, were repatriated to the shareholders as dividends. The essence of the offtaking arrangements, when combined with the payment of dividends on an equity basis, was that **each shareholder's** liftings, to the extent **proportional** to their respective equity interests, was obtained at Aramco's approximate cost, including royalties and income taxes.

The pricing mechanism employed by Aramco **continued** to insure that historical incentives for each shareholder to **offtake** its share of Aramco's production were maintained. The pricing agreement which **was** in effect during 1967 provided that each shareholder's entitlement to **Aramco's** production was, based in part on each shareholder's equity interest and in part on each shareholder's liftings in prior years. In order to provide incentives for liftings and encourage each shareholder to purchase at least its share of Aramco's production, the four shareholders agreed to initiate a special incentive dividend procedure. This procedure adopted a "quarter-way" pricing concept under which approximately 75 percent of Aramco's profits on "unmatched" crude liftings of a shareholder, i.e., crude liftings in excess of the proportional equity interests of the four **shareholders**, was **specially allocated to the overlifter**.

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During 1967, as well as in prior years, the four shareholders were entitled to all of Aramco's production, less the portion Aramco was required to furnish directly to local Middle Eastern governments. Aramco's 1967 production of crude oil **and refined** products was approximately **949,000,000** barrels, of which approximately **921,000,000 barrels** were **sold to** the offtaking subsidiaries of the four shareholders. Appellant's offtaking subsidiary purchased approximately **176,693,000** barrels of crude oil and refined products, for which it paid **\$317,700,000**. Aramco's tax-paid cost for this amount was approximately **\$205,700,000**, yielding a profit to Aramco of approximately **\$112,000,000**. Aramco's total net earnings for 1967 were approximately **\$588,100,000** and total dividends declared to shareholders for 1967 were **\$592,000,000**, including **special** incentive dividends of **\$152,200,000**. Of the **\$592,000,000** appellant's share was **\$132,000,000**. Since appellant was not an overlifter in 1967, it did not receive any special incentive dividends. The crude oil and refined products purchased by appellant's offtaking subsidiary from Aramco in 1967 were either transferred to other members of appellant's unitary group or sold to third parties, including appellant's affiliates.

As a result of the political turmoil in Indonesia following World War II, appellant and Texaco were unable to commence development of the concession held by CPI until 1949. By 1967, however, CPI's crude oil liftings exceeded **125,000,000** barrels. Pursuant to the operating agreement with the Indonesian government in effect during 1967, CPI was required to provide up to 25 percent of its total annual production for local consumption at a price substantially less than the world market price. The balance of CPI's production was available for sale to the two shareholders' offtaking subsidiaries at actual market prices. Like Aramco, however, CPI's pricing mechanism was structured to provide incentives for each shareholder to **offtake** at least its equity share of **CPI's** production. In effect, the pricing mechanism selected **was** the "quarter-way" pricing concept, previously discussed, whereby 75 percent of CPI's profits on "unmatched" crude purchases would be paid to the overlifters, which was designed to allocate CPI's profits approximately on the basis of crude oil purchases.

During 1967, CPI's total liftings of crude oil were approximately **128,800,000** barrels. Of this amount, approximately **83,500,000** barrels represented crude oil sold by CPI to the offtakers for export, while the

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remainder was required for **local** Indonesian use. Appellant's offtaking subsidiary purchased approximately **45,655,000** barrels of crude oil from CPI during 1967, for which it paid CPI approximately **\$72,409,000**. CPI's tax-paid cost for this crude oil was approximately **\$48,394,000**, yielding a profit to CPI of approximately **\$24,015,000**. CPI's total net earnings for 1967 were **\$53,170,000**, while total dividends declared to the two shareholders for that year were **\$53,435,000**. Appellant's share of declared dividends was **\$27,880,000**, which included special incentive dividends of **\$2,380,000**, since appellant was an overlifter for 1967. The crude oil purchased by appellant's offtaking subsidiary from CPI during 1967 was either transferred to **other** members of appellant's unitary group or sold to third parties, including **appellant's affiliates**.

In every year since 1949, the Eastern Hemisphere crude oil and natural gas production to which appellant has been entitled as a **result** of its equity participation interests in Aramco and CPI has exceeded 35 percent of appellant's worldwide supply of crude oil and natural gas liquids. Since 1958, such entitlements have represented at least 50 percent of appellant's worldwide supply. For 1967, appellant's entitlements to Aramco's and CPI's production amounted to 52 percent of its worldwide supply of crude oil and natural gas liquids.

As reported for the 1967 income year, after the elimination of intercompany transactions and intercompany dividends, appellant's **total combined** net income was **\$275,502,607**. Of this amount, **\$143,151,647** represented dividends received by appellant or its subsidiaries from affiliated petroleum corporations. Based on the combined report which reflected an apportionment fraction of 36.861845 percent, appellant and its subsidiaries paid California franchise taxes of **\$7,108,874**.

After an audit, respondent concluded that all dividends reported by appellant and its subsidiaries as apportionable business income constituted nonbusiness income specifically allocable in full to the commercial domicile of the recipient. Accordingly, respondent determined that the worldwide apportionable business income of appellant and its subsidiaries, before application of the interest offset provisions, was **\$149,358,684**, and further determined that **\$130,274,037** of dividend income received by appellant and its California-based subsidiaries was nonbusiness income

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specifically allocable in full to 'California. Respondent also determined that **\$3,459,271** of dividends received by appellant's subsidiaries domiciled outside the state was not taxable in California. Accordingly, respondent recomputed the tax liabilities of appellant and its California subsidiaries to be **\$11,976,327**, and proposed the **\$4,867,453** deficiency here in issue. Respondent also determined that appellant's apportionment fraction was 36.373293 percent.

I. APPLICABLE STATUTES AND REGULATIONS

In 1966 California adopted the Uniform Division of Income for Tax Purposes Act (UDITPA) as set forth in sections 25120 through 25139. UDITPA prescribes a comprehensive statutory scheme of apportionment and allocation rules as the method of measuring that portion of the income of a multistate taxpayer subject to the California franchise tax. The expressed purpose of UDITPA was to make uniform the law of those states which enact it. '(Rev. & Tax. Code, § 25138.) 'Contemporaneously with the enactment of UDITPA, section 25101 was amended to provide, in pertinent part:

When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120 of this chapter) ... (Emphasis added.)^{4/}

^{4/} Prior to the effective date of UDITPA, section 25101 provided that **the income** of a corporation engaged in business within and without the state which is derived from or attributable to sources within the state:

shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, pay roll, value and **situs** of tangible property or by reference to any of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this State, . . .

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Section 25121 provides that any taxpayer having income from business activities within and without this state "shall allocate and apportion its net income as provided in this act." (Emphasis added.)

For purposes of determining how much of the income of a multistate taxpayer is taxable by each state in which it is doing business, **UDITPA** distinguishes between "business income," which is apportioned by formula, and "nonbusiness income," which is to be specifically allocated by **situs** or commercial domicile. Business income is defined as:

income arising from transactions and activity in the regular course of the taxpayer's trade or **business** and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. (Rev. & Tax. Code, § 25120, subd. (a).) ^{5/}

Nonbusiness income, on the other hand, is defined as "all income other than business income." (Rev. & Tax. Code, § 251'20, subd. (d).) Section 2'5123, which limits the **applicability** of the specific allocation provisions to nonbusiness income, provides:

Rent and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated **as provided** in Sections 25124 through 25127 of this act.

5/ Section 25120 contains both a "transactional" and a "functional" test for the identification of business income. Under the "transactional test" income is business income where it arises from "transactions and activity in the regular course of the taxpayer's trade or business," while the "functional test" classifies business income as "income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

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The specific allocation of dividends, to the extent they constitute nonbusiness income, is controlled by section 25126, which states:

Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

Respondent's regulations provide, in pertinent part:

Section 25120(a) defines "business income" as income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. In essence, the business income of the taxpayer is that portion of the taxpayer's entire net income which arises from the conduct of the taxpayer's **trade or** business operations. For purposes of administration of Sections 25120 to 25139, inclusive, the income of the taxpayer is business income unless clearly classifiable as **nonbusiness** income under Sections 25120 to 25129, inclusive and the regulations thereunder. (Cal. Admin. Code, tit. 18, reg. 25120, subd. (a) (art. 2).)

Respondent's regulations also provide:

The classification of income by the labels customarily given them, such as interest, dividends, rents, royalties, capital gains, is of no aid in determining whether that income is business or nonbusiness income. The gain or loss recognized on the sale of property, for example, may be business income or nonbusiness income depending upon the relation to the taxpayer's trade or business. (Cal. Admin. Code, tit. 18, **reg.** 25120, subd. (c) (art. 2).)

II. LEGISLATIVE HISTORY OF SECTION 25140

Respondent's first argument is based on the legislative history of **UDITPA** and section 25140, which were enacted simultaneously, and **pre-UDITPA** administrative practice, which was to treat most dividends as

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nonbusiness income taxable at the commercial domicile of the recipient. It is respondent's position **that**, by enacting section 25140, the Legislature intended no change in this administrative practice even though the proper treatment of dividends under pre-UDITPA law was being litigated^{6/} at the time UDITPA and section 25140 were **adopted**.^{6/} Section 25140 originally provided that the Legislature did not intend for dividends to be taxed except in the state of the recipient's commercial domicile. Although section 25140 was amended to delete the specific language relied upon, respondent, **nevertheless**, concludes that the Legislature intended dividends to be taxed under UDITPA in the same manner as they had been prior to the act.

As originally enacted in 1966, section 25140 (Stats. 1966, ch. 2, p. 181) read as follows:

It is not the intention of the Legislature in enacting this article to provide **for** the taxation of intercorporate dividends except in the state of commercial domicile of the receiving corporation.

Assembly Bill 11, which contained both UDITPA and section 25140, was adopted by the Legislature on April 4, 1966, and signed by the Governor on April 13, 1966. Pursuant to section 8 of the bill, however, UDITPA and section 25140 were not to become effective until January 1, 1967.

^{6/} During the time UDITPA was being adopted and section 25140 was being enacted and amended, two cases involving the treatment of dividends under pre-UDITPA law were pending in the California courts. Ultimately, well after the adoption of UDITPA and section 25140, the California Supreme Court, in Pacific Telephone and Telegraph Co. v. Franchise Tax Board, 7 Cal.3d 544 [102 Cal.Rptr. 782, 498 P.2d 1030] (1972) and Safeway Stores, Inc. v. Franchise Tax Board, 3 Cal.3d 745 [91 Cal.Rptr. 616, 478 P.2d 48] (1970) held that under pre-UDITPA law, dividends from unitary subsidiaries were nonunitary (nonbusiness) income taxable at the commercial domicile of the recipient shareholders. It is important to note that the treatment of dividends under UDITPA was not before the court in either of these cases.

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Insofar as is relevant to this appeal, Assembly Bill 11, as originally introduced, contained only UDITPA (§§ 25120-25139) and the conforming amendment to section 25101. Section 25140 was not added to the bill until April 4, 1966, the last day of the 1966 Regular Budget Session and the day on which the bill was approved by the Legislature. During the closing hours of deliberation by the Senate on that date, the bill **was amended** to add section 25140, over the objections of both the author of the bill and respondent, as a result of lobbying efforts by the California Manufacturers' Association on behalf of a number of foreign corporations. Neither the Senate nor the Assembly had an opportunity to consider the full import of section 25140 prior to passage of the bill, including the potential adverse impact on California-based corporations or the potential prejudice to litigants involved in the two **cases then** pending in the California courts involving the taxation of **inter-**corporate dividends under pre-UDITPA law. However, these points were brought to the attention of the Legislature immediately following enactment, and led to the introduction of Senate Bill 104 on May 24, 1966, to amend section 25140 and expressly delete the declaration of legislative intention contained therein.

In view of the **importance attached** to the effective repeal of the legislative intent contained in section 25140 prior to the January 1, 1967, effective date of UDITPA, it was necessary for Senate Bill 104 to be introduced in the 1966 First Extraordinary Session of the Legislature pursuant to the call contained in the February 9, 1966, and succeeding, Proclamations of the Governor. (**See** Stats. 1966, 1st Ex. Sess. 1966, p. 247-251.) The only two items in the Proclamation which were potentially relevant to the subject matter of Senate Bill 104 were:

Item No. 1. To consider and act upon legislation relative to accounting procedures used by the state with respect to revenue derived pursuant to the Bank and Corporation Tax Law.

* * *

Item No. 37. To consider and act upon legislation relative to accounting procedures used by the state with respect to revenues. (Stats. 1966, 1st Ex. Sess. 1966, p. 247, 249.)

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Senate Bill 104, as introduced on May 24, 1966, replaced the original version of section 25140 with the following paragraph:

The Franchise Tax Board shall adopt accounting procedures which will separately reflect the revenues attributable to dividends received by corporations having commercial domiciles in this state.

A second paragraph of the amendment to section 25140, dealing with the pending litigation, ~~was~~ added at the request of respondent on May 26, 1966,⁷ which provided:

In view of pending litigation concerning the proper treatment of intercompany dividends, it is not intended by enactment of this act that any inference be drawn from it in such litigation.

Senate Bill 104, which received the support of a number of California-domiciled corporations, was approved by the Legislature on July 7, 1966, and signed by the Governor on July 25, 1966. Thus, we see that respondent initially relies, as primary evidence of legislative intent, on statutory language that was expressly repealed by the Legislature before it ever became law in California.

It is a settled rule of statutory construction in California that the very fact that a prior act is amended demonstrates an intent to change the pre-existing law. (Eu v. Chacon, 16 Cal.3d 465, 470 [128 Cal. Rptr. 1, 546 P.2d 289] (1976); Clements v. T. R. Bechtel Co., 43 Cal.2d 227, 232 [273 P.2d 5] (1954); see also Judson Steel Corp. v. Workers' Comp. Appeals Bd., 22 Cal.3d 658, 666, fn. 5 [150 Cal. Rptr. 250, 556 P.2d 564] (1978).) Since section 25140, as originally enacted,

⁷/ On the same date, the first paragraph of section 25140 was amended to read:

Accounting procedures shall be adopted which, will separately reflect the revenues attributable to dividends received by corporations having commercial domiciles in this state.

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codified respondent's pre-UDITPA administrative practices regarding dividends, the normal inference to be drawn from the **express repeal** of the original language would be that the Legislature was thereby revoking its previously expressed intention to perpetuate respondent's pre-UDITPA treatment of dividends. Although respondent has consistently maintained that the Legislature did not intend to change California's method of taxing dividends, it has not been able to produce any supporting evidence in the nature of legislative committee reports, records of legislative deliberations, or even statements made by individual legislators while the Legislature was considering Senate Bill 104. The only contemporaneous material which respondent has submitted in this case consists generally of documents that were prepared after the passage of Senate Bill 104 and submitted to the Governor at the time he was deciding whether to sign or veto the bill. Specifically, the documents in question are a Department of Finance memorandum dated July 12, 1966; a Legislative Analyst's memorandum of May 26, 1966.; and a memorandum from respondent dated July 13, 1966. Since the authors of these documents were not legislators, their understanding of the purpose and effect of Senate Bill 104 is not persuasive evidence of the Legislature's intent. (Royal Globe Co., Inc. v. Superior Court, 23 Cal.3d 880 [153 Cal.Rptr. 842, 592 P.2d 329] (1979).) Nevertheless, since respondent's position regarding dividends has historically been based largely on its view of legislative intent, we believe it is appropriate to examine these memoranda to see if they indeed provide any support for respondent's position.

The Department of Finance memorandum, to the extent relied upon by respondent, states:

This bill in effect repeals the California Manufacturers' amendment and restores the situation to where it was before addition of Section 25140 to Chapter 2.

Apparently, respondent interprets this statement to mean that the law was restored to a pre-UDITPA status. However, we read this sentence as simply stating that Senate Bill 104 restored UDITPA to its original form. In other words, UDITPA and not prior law was to control the taxation of dividends in California.

The Legislative Analyst's analysis of Senate Bill 104, as quoted by respondent, provides:

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In its present form this section specifies that it is not the intention of the Legislature to provide for the taxation of inter corporate . . . dividends except in the state of commercial domicile of **the** receiving corporation. The Franchise Tax Board states that this language merely restates the existing practice.

Once again we can find no support for respondent's argument in this analysis which says that section 25140 in its present form, before amendment, merely restates respondent's administrative practice.

Respondent's memorandum to the Governor states, in pertinent part:

Senate Bill 101 now eliminates the language in 'section 25140 relative to the legislative intent as to the taxability of intercompany dividends and adds other language which prevents either party in the current litigation from deriving any advantage in the litigation from the elimination of the original language. Thus, under the -bill, the law will remain as it was prior to the addition of Section 25140 to Assembly Bill 11, and leave the entire question as to the taxability of intercompany dividends to be decided solely by the pending litigation.

The most that can be gleaned from respondent's memorandum is either: (1) **that the** amendment of section 25140 would leave the pre-UDITPA law as it was, with the question of the taxability of intercompany dividends under pre-UDITPA law to be decided by the courts in the pending litigation; or (2) that **the taxability** of post-UDITPA dividends in California would be controlled by UDITPA as it read prior to the addition of section 25140, which in respondent's opinion would continue the pre-UDITPA method of taxing dividends, leaving to the courts the definition of that method in the then-pending litigation. If the former interpretation is correct, it does not strengthen respondent's **position** since it does not apply to UDITPA. On the other hand, if the latter interpretation correctly reflects respondent's opinion, it is most difficult to attribute such an intent to **the** Legislature,. Initially, it must be recognized **that** the declaration of legislative intent contained in section 25140 deals only with the effect of that section on pending litigation, not with the effect of pending litigation

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on construction of UDITPA. It does no more than state that any change in the law resulting from the enactment of UDITPA, or from the repeal of section 25140's original language, shall not be regarded as an expression by the Legislature of its views with respect to the proper treatment of dividends under pre-UDITPA law. Furthermore, respondent's argument would require us to conclude that, despite the enactment of **new and** comprehensive statutory provisions dealing specifically with the classification and treatment of income from intangibles, the Legislature intended to delegate to the judiciary the power to decide how dividends would be taxed under UDITPA in pending cases involving the treatment of dividends under **pre-**UDITPA law. We cannot conceive that the Legislature would endorse such an intention.

Respondent also seeks support from the **use** in the amended version of section 25140 of what it describes as specialized terms such as "separately reflect" and "commercial domicile" as indicative of the Legislature's intent that dividends would be considered as nonbusiness income under UDITPA. This argument is refuted by respondent's memorandum to former Governor Edmund G. Brown, Sr., which stated that the language in the first paragraph of the bill providing for the accounting for dividends was "unimportant and was only inserted in the bill to bring the matter within the call of the First Extraordinary Session." (See also Department of Finance memorandum of July 12, 1966, to the Governor.) Aside from satisfying the legislative "call," the Legislature, at best, could only have intended the first paragraph of the amendment to section 25140 to direct respondent to conduct a statistical survey in order to quantify dividends received by California-based corporations.

Next, respondent argues that UDITPA was not intended to change the existing method of taxing dividends in view of the fact that the amendments to section 25140 were not estimated to have an appreciable revenue effect. (See Legislative Analyst's analysis of Senate Bill 104 dated May 26, 1966.) Such estimate is not surprising since most multistate and multinational corporations are domiciled outside California.⁸⁷ It is

⁸⁷ In this respect it should be noted that among the proponents of the original version of section 25140 were numerous foreign corporations, while the supporters of the amended version of section 25140 included a large number of California-domiciled corporations.

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therefore probable that the Legislative Analyst believed that the apportionment of business-related dividends of out-of-state corporations would substantially offset any loss in revenue resulting from the apportionment of business-related dividends received by corporations with California domiciles. In fact, more recent data submitted by respondent in post-hearing memoranda indicate that the net financial effect on state revenue from a change in the method of taxing dividends would be insignificant, although there would be some shift in tax burden from domestic to foreign corporations and possibly some temporary revenue impact because of pending litigation and the effect of the statute of limitations.

Furthermore, **as support** for its position that section 25140 **requires** the allocation of dividends to California, respondent relies on the fact that in recent years the Legislature has considered and rejected bills which would have changed that result. In particular, respondent points to the failure of the Legislature to approve Senate Bill 1713 introduced March 8, 1976, **as** affirmative evidence of legislative -agreement with its **position** on the treatment of dividends. We must reject **respondent's unenacted legislation argument** on the basis that such legislation has little if any evidentiary value in **attempting** to discern legislative intent. (Sacramento Newspaper Guild v. Sacramento County Bd. of Suprs., 263 Cal.App.2d 41, 58 [69 Cal.Rptr. 480] (1968).)

Since section 25140, as originally enacted, would have resulted in a **codification** of certain **pre-UDITPA** administrative practices of respondent in regard to the treatment of dividends, the express repeal of such provision before it ever became effective must be regarded as an explicit rejection by the Legislature of **any intent** to codify pre-UDITPA law **on the** treatment of dividends.^{9/}

^{9/} In holding that the Legislature must be presumed to have intended a change in the law by the deletion of a statutor'y provision, the court in Southern Pacific Co. v. McColgan, 68 Cal.App.2d 48, 54-55 [156 P.2d 811] (1945) stated:

The presumption is, of course, **that** the Legislature by deleting the express provision for allocation of income from intangibles intended a **substantial** change in the law. [Citations omitted.]

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For the **reasons discussed** above, we conclude that respondent's claim that by the enactment of section 25140, the Legislature specifically intended UDITPA to operate as a codification of pre-UDITPA law or administrative **practice** as to the treatment of dividends must be rejected.

10/ This **conclusion** is consistent with the statements of Senator Miller, Jr., the author of **Senate Bill 104**, in his letter to the Governor dated July 8, 19.66, urging approval of the bill, wherein he stated:

The. purpose of the bill was to delete from the Uniform Division of Income for Tax Purposes Act the provisions of Section 25140, in Assembly Bill 11 of the 1966 Budget Session, which has been signed into law. **This** section was not a part of the Uniform Act, was the only amendment to the bill, and was included on the last day of the **Budget Session**. Subsequent review of Section 25140 indicates that it may be detrimental to the treatment of intercorapany dividends of California based companies with subsidiary operations in other states and may unfairly favor companies having headquarters outside the State of California, yet enjoying the privileges of our market.

Moreover, and most important, it **is my** considered belief that if this bill, Senate Bill 104, is not signed, the provisions of Section 25140 could prejudice pending litigation on this **subject** in the Superior Court of San Francisco. The traditional practice of the Legislature has been to not enact laws which would potentially influence pending litigation. I am **convinced the** practice is sound and should be followed in this instance.

* * *

This legislation is strongly endorsed by a large number of California based corporations with subsidiaries in other states.

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III. PRE-UDITPA COURT CASES AND BOARD OPINIONS

Respondent also argues that certain **pre-UDITPA** judicial decisions dealing with the taxation of income from intangibles require a determination that the dividend income at issue in this appeal is nonbusiness income.' The case which is at the heart of respondent's argument is Southern Pacific Co. v. McColgan, 68 Cal. App.2d 48 [156 P.2d 8] (1945), which **involved the** proper treatment of dividends received by a foreign corporation **operating** a unitary transportation business in California and other states? The dividends in question were received from stock which was held to advance the interests of the unitary business and was found to be integrally connected with that business. (Southern Pacific, supra, 68 Cal. App.2d at 80-81.) The relevant **allocation^{11/}** statute was section 10 of the Bank and Corporation Income Tax Act as amended in 1935. (Stats. 1935, ch. 275, p. 960.)

Prior to the 1935 amendmept, section 10, which applied to corporations doing business within and without the state, provided not only for the allocation of net income which was derived from "business done" within the state, but **also provided** that "[i]ncome from intangible personal property which is not deductible under the provisions of subsection (h) of section 8 hereof shall be subject to allocation." (Stats. 1931, ch. 1066, p. 2226.) The court first acknowledged that the amendment, which deleted the language quoted above, effected a substantial change in the law; therefore, it was not

10/ (Continued)

Again, may I urge that you sign this bill to permit pending litigation to proceed without potential prejudice. Further, your affirmative action would clearly demonstrgte **the** interest of government in an equitable tax **climate to** encourage the location and expansion of business and industry headquarters in our state.

11/ Prior to the adoption of UDITPA the term "allocation" referred to allocation by formula; the term **"apportionment"** did not appear in a statutory context until the adoption of UDITPA.

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necessary to consider the propriety of allocating the dividend income by formula. (Southern Pacific, supra, 68 Cal.App.2d at p. 54.) Next, the court thought that the statute purported to include in the measure of tax all the net dividend income of all corporations doing business in the state, but held the statute to be effective only to the extent the state could constitutionally include such dividends in the measure of the tax. (Southern Pacific, supra, 68 Cal.App.2d at p. 57.)

In devising the necessary constitutional basis the court noted that the receipt of dividends did not constitute "business done" and only income from "business done" was allocated by section 10. But, according to the court, under the maxim mobilia sequuntur personam California could include in the measure of tax, free from constitutional limitation, all income from intangibles which have a taxable situs in this state. In the case of a foreign corporation such income was said to be taxable in this state only if it is in some way connected with the corporation's California franchise. (Southern Pacific, supra, 68 Cal.App.2d at p. 62.) Since the stock from which the dividends accrued was integrally connected with the taxpayer's unitary transportation business, the dividends were held to be taxable at the commercial domicile of that business, which the court found to be in California. (Southern Pacific, supra, 68 Cal.App.2d at p. 80-82.)

With respect to any efficacy which Southern Pacific might have after the enactment of UDITPA, three factors are paramount.

First, although recognizing the close connection between the stock ownership and the taxpayer's unitary business, the court did not address the issue of whether income derived therefrom was subject to apportionment. Contrary to section 10 as amended to provide only for formula allocation of "income from business done", UDITPA expressly requires the entire "net income" of a multistate taxpayer, including income from intangibles, to be specifically allocated and apportioned by formula in accordance with specific apportionment and allocation rules. (See Rev. & Tax. Code, § 25121.) These rules authorize application of a commercial domicile situs rule to income from intangibles, including dividends, only to the extent that such income is not classified as business income under section 25120.

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The second aspect of Southern Pacific is the jurisdictional context in which the **commercial domicile situs rule** was applied. As we have **noted**, the court determined **that** the applicable taxing statute, although all-encompassing on its face, was effective only **to** the extent that the state could constitutionally include the dividends in **the measure** of the tax. Thus, the concept of commercial domicile, as a basis for taxing income from intangibles, was formulated by the court while considering the maximum extent of the state's constitutional power to tax the dividend income of a foreign **corporation**.^{12/}

^{12/} An analysis of Southern Pacific and other pre-UDITPA cases suggests an attempt to wrestle with real or imagined constitutional impediments to the taxability of dividends on other than **situs principles**. It is conceivable that similar problems concerned the drafters of the original UDITPA provisions wherein all capital gains and dividends were specifically allocated. (See, J. H. Peters, The Distinction Between Business Income and Nonbusiness Income (1973) 25 So. Calif. Tax Inst. 251, 272.) In any event, these perceived constitutional limitations have been laid to rest by the recent United States Supreme Court decision in Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 [63 L.Ed.2d 510] (1980) where the court held that neither the Due Process Clause nor the Commerce Clause was offended by Vermont subjecting Mobil's dividend income, including dividends from Aramco, to a fairly apportioned income-tax where the income was earned in the course of **activities related** to the conduct of Mobil's petroleum business in Vermont. In Mobil the Supreme Court stated:

Although a fictionalized **situs** for intangible property sometimes has been invoked to avoid multiple taxation of ownership, there is nothing talismanic about the concepts of "business **situs**" or "commercial domicile" that automatically renders those concepts applicable when taxation of income from intangibles is at issue. The Court has observed **that** the maxim *mobilia sequuntur personam*, upon which these fictions of **situs** are based, "states a rule.

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On the other hand, UDITPA is not concerned with the maximum extent of a state's jurisdictional reach over a foreign or domestic corporation's net income, but rather with uniform rules for the equitable division of such income among those states having the power to tax.

The third aspect of Southern Pacific is the court's commentary on the source and situs provisions incorporated in section 10 after the year in issue. This commentary is helpful in understanding later cases relying on Southern Pacific. After acknowledging that the statute as it read during the year in issue was constitutionally valid only as applied to dividend income derived from stock with a California **situs**, the court noted that it had subsequently been amended. (Southern Pacific, supra, 68 **Cal.App.2d** at p. 62.) As amended, **section** 10 required that income included in the measure of tax be "derived from or attributable to sources within this State" and provided that "income derived from or attributable to sources within this State includes, income from tangible or intangible property located or having a **situs** in this State ..." (Stats. 1939, ch. 1050, p. 2944.) The specific language sourcing income from tangible or, intangible property to California if the property had a **situs** in this state was later incorporated in section 23040. In this statutory setting it is **apparent** why later pre-UDITPA decisions construing section 10 and its successor sections relied on the **situs** principles enunciated in Southern Pacific. (See, e.g., Pacific Telephone & Telegraph Co. v. Franchise Tax Board, 7 **Cal.3d** 544 [102 **Cal.Rptr.** 782, 498 **P.2d** 10301 (1972)]

12/ (Continued)

without disclosing the reasons for it." First Bank Stock Corp. v. Minnesota, 301 U.S., at 241 (1937). The Court also has recognized that "the **reason** for a single place of taxation no longer obtains" when the taxpayer's activities with respect to the intangible property involve relations with more than one jurisdiction. Curry v. McCannless, 307 U.S. 357, 367 (1939). (Emphasis in original.) (Mobil Oil Corp. v. Commissioner of Taxes, supra, 445 U.S. at 445.)

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(dividends); Safeway Stores, Inc. v. Franchise Tax Board, 3 Cal.3d 745 [91 Cal.Rptr. 616, 478 P.2d 48] (1970) (dividends); Fibreboard Paper Products Corp. v. Franchise Tax Board, 268 Cal.App.2d 363 [74 Cal.Rptr. 46] (1968) (interest); Rainier Brewing Co. v. McColgan, 94 Cal.App.2d 118 [210 P.2d 233] (1949) (royalties).)

None of the pre-UDITPA court cases which specifically allocated income from intangibles, including Southern-Pacific, ever applied either a transactional test or a functional test as now contained in UDITPA.. For example, in Rainier Brewing Co. v. McColgan, supra, the court relied almost exclusively on the sourcing language contained in section 10 (now section 23040) in finding royalty income derived from trademarks, trade names and labels used in the taxpayer's brewing business to be taxable in full in California under the mobilia doctrine. It should be noted, however, that the taxpayer in Rainier did business only in California.

In a similar vein, the court in Fibreboard Paper Products Corp. v. Franchise Tax Board, supra, relied on the source and situs language of section 23040 in holding that interest income derived from working capital investments was taxable in its entirety at the taxpayer's California commercial domicile. The court was unconcerned with the relationship between the investments and the taxpayer's business, holding that income from intangibles with a California situs was "from a California 'source' because section 23040 says it is, and the statute does not provide that the 'source' of such income may be qualified by the purpose for which the intangibles are held." (Fibreboard Paper Products Corp. v. Franchise Tax Board, supra, 268 Cal.App.2d at p. 368; see also American President Lines, Ltd. v. Franchise Tax Board, 3 Cal.App.3d 587 [83 Cal.Rptr. 702] (1970).)

The same pattern was also followed by the California Supreme Court in Safeway Stores, Inc. v. Franchise Tax Board, supra, and Pacific Telephone & Telegraph Co. v. Franchise Tax Board, supra, which held dividends from unitary subsidiaries to be taxable at the recipient's commercial domicile, while disregarding the relationship of the stockholdings to the taxpayer's unitary business. The rationale was summarized in Pacific Telephone & Telegraph, supra, 7 Cal.3d at p. 547-548, where the court stated:

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As we pointed out in Safeway,, "the franchise tax is to be measured only by that portion of the corporation's income which had its 'source' in California. However, the 'source' of dividend income is the stock upon which the dividend was paid, and the taxable **situs** of the stock is generally held to be at the domicile of the owner of the stock. (See Miller v. McColgan (1941) 17 **Cal.2d** 432, 437-440 ...; Robinson v. McColgan (1941) 17 **Cal.2d** 423 . . .)" (3 **Cal.** 749, fn. 3.) Under the doctrine of mobilia sequuntur personam dividend income from **securities** is specifically applicable [sic] [allocable] to the domicile of the owner of the stock. (Fibreboard Paper Products Corp. v. Franchise Tax Bd., 268 **Cal.App.2d** 363, 367 [74 **Cal.Rptr.** 46]; Southern Pacific Co. v. McColgan, 68 **Cal.App.2d** 48, 53-56 (156 **P.2d** 811.)

Most, if not all, of the cases considered above relied on Miller v. McColgan, 17 **Cal.2d** 432 [110 **P.2d** 419] (1941), which applied the mobilia principle in sourcing dividend income received from a foreign corporation by a California resident at the **situs** of the stock. In reaching this decision the court recognized the difference between the immediate source of the income, which was the stock, and the ultimate source of the income, which was the declaring corporation's business activities. According to respondent, it is this fundamental distinction which requires a conclusion that dividend income is nonbusiness income.

We do not quarrel with the distinction drawn by the court in Miller v. McColgan, supra. For the purpose of distinguishing between business income and nonbusiness income under UDITPA, however, it simply does not go far enough. For example, even conceding that the stock itself is the immediate source of the dividend income, section 25120 requires consideration of the relationship between the stock and the taxpayer's unitary business activity.

Prior to the adoption of UDITPA, the tax of a unitary business was based on income derived from sources within this state, and section 25101 expressly permitted the use of any allocation method fairly calculated to determine net income from California sources. Given the additional source and **situs** language of section 23040 coupled with the express or implied constitutional

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concerns, it is apparent why the California courts found the application of historical **situs** concepts to intangible income to be consistent with the statutory framework then ineffect. With the adoption of UDITPA, however, section 25101 was amended to mandate **application** of the UDITPA provisions in determining income derived from California sources. "**Situs**" is not mentioned in section 25120, subdivision (a), and the concept is not relevant to the classification of income under the business income definition contained in UDITPA. Whether income from intangibles should be classified as business income and apportioned by formula, or as nonbusiness income and specifically allocated under UDITPA, does not turn on historical sourcing concepts, but rather requires consideration of **the** relationship between the intangible and the taxpayer's **unitary** business.

For these reasons we conclude that Southern Pacific and its progeny do not control the **definition** of "**business income**" contained in UDITPA. (See Times Mirror Co. v. Franchise Tax Board, 102 Cal.App.3d 872 [162 Cal.Rptr. 630] (1980) (dictum).)

Respondent also contends that its position is supported by pre-UDITPA decisions of this board. Since the functional test language contained in section 25120, subdivision (a), was **patterned** after language employed in certain pre-UDITPA decisions of this board dealing with income from intangibles, those decisions are relevant. However, to suggest that pre-UDITPA decisions of this board which did not consider the relationship of the income-producing property to the taxpayer's business operations are relevant, as respondent does, is incorrect.

The functional **test language** contained in section 25120, subdivision (a), was patterned after language contained in three pre-UDITPA appeals involving royalty income: Appeal of Houghton Mifflin Co., decided March 28, 1946; Apl of International Business Machines Corp., decided October 7, 1954; and Appeal of National Cylinder Gas Co., decided February 5, 1957. (See J. H. Peters, The Distinction Between Business Income and Nonbusiness Income, (1973) 25 So. Calif. Tax Inst. 251, 276-279.) In those decisions involving income from patents or copyrights received by foreign corporations, it was held that income from **intangibles** is **unitary** income **subject** to apportionment by formula where the acquisition, **management**, and disposition of the **intangibles** constitute an **integral** part of the **owner's** regular business operations. However, the functional **test** was

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not involved in every pre-UDITPA appeal dealing with the classification of income from intangibles as unitary (business) or nonunitary (nonbusiness) income. In fact, this test was seldom applied in resolving the tax treatment of intangible income outside the royalty area,^{13/} in view of the pre-UDITPA judicial decisions previously discussed, which required the application of **situs** principles to the taxation of interest and dividend income received by a taxpayer with a California domicile, regardless of the relationship of the intangibles to the taxpayer's unitary business.

Most of the pre-UDITPA appeals decided by this board involving income or loss from stock and debt securities were resolved solely on **situs** principles and, therefore, are not helpful in construing the language of section 25120, subdivision (a).^{14/} UDITPA's definition

^{13/} But see Appeal of Marcus-Lesoiné, Inc., Cal. St. Bd. of Equal., July 7, 1942 (interest income from conditional sales contracts arising out of the multistate merchandising activities of a California corporation held to be unitary income since the "acquisition, management and liquidation" of the intangibles constituted integral parts of the corporation's regular business operations); cf. Appeal of American Airlines Inc., Cal. St. Bd. of Equal., Dec. 18, 1952 (interest income on U.S. Treasury notes which were used to pay the federal tax liabilities of a foreign corporation's unitary business held to be nonunitary income, on the ground that the source of the interest was not the regular operations of the unitary business, as in Marcus-Lesoiné, but rather the taxpayer's investment in government securities); see also Appeal of American Snuff Co., Cal. St. Bd. of Equal., April 20, 1960 (interest income from a foreign corporation's loans to its employees held to be unitary income, because the loans were made for the purpose of increasing employee efficiency and, thus, contributed directly to the operations of the unitary business).

^{14/} Included among the few exceptions to the strict application of **situs** concepts were cases involving certain special fact situations not dealt with in pre-UDITPA judicial decisions regarding intangibles. (See, e.g., Appeals of Pacific Telephone & Telegraph Co., Cal. St. Bd. of Equal., May 4, 1978 (gain received by a domestic corporation from sales of stock pursuant to a reorganization of the unitary business held to be unitary income); Appeal of Capital Southwest Corp., Cal. St. Bd. of Equal., Jan. 16, 1973 (dividends and capital gains received by a foreign small business investment company held to be unitary income)).

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of business income specifically rejects historical *situs* principles and mandates a consideration of the *interrelationship* between the intangible--whether it is stock, debt, a patent or a **copyright--and the taxpayer's** regular unitary business operations.

IV. APPLICATION OF THE STATUTES AND REGULATIONS

Finally, we turn our attention to the statutory **framework** of UDITPA, the interpretive regulations and their application to the facts of this appeal. A review of the comprehensive UDITPA provisions indicates that they prescribe an exclusive statutory scheme of apportionment and allocation rules for measuring that portion of the income of a multistate taxpayer subject to the California franchise tax. The exclusivity of these rules was confirmed by the amendment to section 25101 contemporaneously with the enactment of UDITPA. (Compare Rev. & Tax. Code, § 25101 as amended by Stat. 1966, ch. 2, p. 177 with previous § 25101.) Section 25128 requires "business income" to be apportioned by formula, while section 25123 provides that "nonbusiness income" shall be specifically allocated. Business income may include all classes of income, including income from both tangible and **intangible property such as** rents, capital **gains**, interest, dividends and patent and copyright royalties. However, the classification of income by the labels customarily given them is of no aid in determining whether the income is business or nonbusiness income. (See Appeal of General Dynamics Corp., Cal. St. Bd. of Equal., June 3, 1975.)

The UDITPA definition of "business income" involves two independent tests. The first **test is** concerned with whether the "transaction or activity" which gave rise to the income in question occurred in the regular course of the taxpayer's trade or business. The second test **is based** on the "functional" integration of the income-producing property and the taxpayer's unitary business operations. Under the transactional test, income is classified as business income if the transaction which generated the income occurred in the regular course of the taxpayer's trade or business. (Appeal of General Dynamics Corp., supra.) Under the functional test, income is business income if the acquisition, management and disposition of the income-producing property constitute integral parts of the taxpayer's regular trade or business operations., (Appeal of Kroehler Manufacturing Co., supra; Appeal of Borden, Inc., supra; Appeal of New York Football Giants, Inc.,

supra; but see, Mobil Oil Core v. Commissioner of Taxes, 445 U.S. 425 [63 L.Ed.2d 510] (1980); ASARCO, Inc. v. Idaho State Tax Commission, -- U.S. -- [73 L.Ed.2d 787] (1982); F. W. Woolworth Co. v. Taxation and Revenue Department, -- U.S. -- [73 L.Ed.2d 819] (1982).)

On its face the functional test requires that consideration be given to the relationship between a taxpayer's intangible property--whether it is stock, debt instruments, patents or copyrights--and the taxpayer's unitary business operations in order to determine whether the income arising therefrom is business income subject to formula apportionment or nonbusiness income subject to specific allocation. Such consideration is intended to provide a jurisdictional nexus between a taxpayer's income and its multistate business operations. If the income-producing property in question is integrally related to the unitary business activities of the taxpayer, the income is business income subject to formula apportionment. On the other hand, if the income-producing property is unrelated to the unitary business activities of the taxpayer, the income is nonbusiness income subject to specific allocation.

It is **appellant's** position that the dividend income **generated** by its stockholdings in Aramco and CPI qualifies as business income under either the transactional test or the functional test.. For the reasons set out below, we believe that within the parameters of the functional test the dividend income in question must be classified as business income,, It is, therefore, not necessary to consider whether the transactional test is satisfied.

Appellant's interests in Aramco and CPI were acquired and maintained in furtherance of and as an integral part of its unitary business operations within and without California. Appellant's fundamental purpose in creating and maintaining Aramco and CPI as affiliated joint venture supply companies was to insure an available supply of crude oil and natural gas liquids for its worldwide petroleum operations. Aramco and CPI were operated under shareholder supply arrangements which effectively precluded them from selling **crude** oil to **unrelated** third parties other than the host governments. By virtue of these various intercorporate agreements, appellant, through its offtaking subsidiaries, was assured of a guaranteed supply of crude oil for its unitary business operations. Appellant's regular use of these crude oil supply rights embodied in its Aramco and CPI stockholdings

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provided a necessary and essential element of its world-wide oil operations. In fact, during the appeal year, appellant's entitlements to Aramco's and CPI's production amounted to 52 percent of its worldwide supply of crude oil and natural gas liquids. Without these interests, appellant's competitive position in the petroleum industry and its ability to effectively utilize its refining and marketing capacities would have been substantially impaired. Appellant's participating equity **interest** in Aramco and CPI contributed materially to the production of operating income from the rest of appellant's unitary business and clearly served to further the operation of the integrated petroleum enterprise conducted within and without this state. Thus, there can be no question that appellant's stockholdings in Aramco and CPI were integrally related to its unitary business.

Contrary to respondent's assertion that the Aramco and CPI dividends represent "investment income" from the passive ownership of 'stock, appellant's **stockholdings** in Aramco and CPI cannot be viewed as an extraneous investment separate and **apart** from its unitary business operations. Respondent's argument fails to recognize that the amount of dividends appellant was entitled to receive from Aramco and CPI did not rest entirely on its equity ownership interest but **was** dependent on the number of barrels of crude oil it purchased from Aramco and CPI during each year. Although respondent recognizes this fact to a limited degree with respect to the overliker incentive dividends, the fact remains that substantially all of appellant's dividends from Aramco and CPI were measured by its crude oil purchases. If appellant had not purchased any oil from Aramco and CPI during 1967, the dividends payable **to** it would have been a small fraction of the dividends it actually received. In such a case, appellant's dividends from Aramco would have been limited to approximately **7 1/2** percent of Aramco's earnings, notwithstanding appellant's 30 percent equity interest. With respect to CPI, appellant's dividends would have been limited to approximately **12 1/2** percent of **CPI's** earnings although appellant's equity interest was 50 percent. The most critical fact ignored by respondent is that appellant's stockholdings in Aramco and CPI were the foundation of its **entitlements** to the crude oil production of those companies.

Respondent argues that the classification of the Aramco and CPI dividends as nonbusiness income is conclusively resolved by regulation 25120, subdivision **(c)(4)** which, according to respondent, provides **that** in

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most instances intercorporate dividends are nonbusiness income even though the declarant and recipient corporations may engage in extensive intercorporate business activities. Respondent's regulation provides:

Dividends. Dividend income is business income when dealing in securities is a principal business activity of the taxpayer. Most other dividends are nonbusiness income.

Example (A): The taxpayer operates a multistate chain of stock brokerage houses. During the year the taxpayer receives dividends on stock it owns for purposes of making a market in that stock. The dividend income is business income.

Example (B): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the monies in those accounts is invested in various common stocks listed on the national stock exchanges. Both the interest and any dividends would be business income.

Example (C): The taxpayer owns all the stock of a subsidiary corporation which is engaged in a business similar to that of the taxpayer. Any dividends received from the subsidiary would be nonbusiness income. (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c) (art. 2).)

Respondent, of course, has been given the authority to adopt reasonable rules and regulations. (Rev. & Tax. Code, § 26422.) However, the validity of a regulation depends upon whether it is consistent with the statute. The applicable standard of review is whether the regulation is arbitrary and capricious or has a reasonable or rational basis. (See generally, Henry's Restaurants of Pomona, Inc. v. State Board of Equalization, 30 Cal.App.3d 1009, 1020-21 [106 Cal.Rptr. 867] (1973); Mission Pak Co. v. State Board of Equalization, 23 Cal.App.3d 120, 125 [100 Cal.Rptr. 69] (1972).)

The parties to this appeal are in agreement that the definition of business income contained in

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section 25120, subdivision (a), was intended to apply with equal force to all forms of income from intangibles, including dividends, interest, royalties and capital gains. Pursuant to the statute, income from intangibles constitutes business income if the intangibles are integrally related to the unitary business activities of the taxpayer. The statutory definition is followed in subdivision (a) of the regulation interpreting section 25120. (Cal. Admin. Code, tit. 18, reg. 25120, subd.. (a) (art. 2).)

The same approach is also taken in the following subdivisions of that regulation: (c)(1) Rents and royalties from real and tangible personal property are business income if the rental of the property is a principal **business** activity of the taxpayer or is related to or incidental to that activity; (c)(2) Gain or loss from the sale or exchange of real or tangible personal property is business income if the property was used to produce business income; (c)(3) Interest income is business income if the income-producing intangible arises out of or was created by the taxpayer's business activity, or if the purpose for acquiring the intangible was directly related to the taxpayer's business activity; and (c)(5) Royalties are **business** income if the income-producing patent or copyright was-created or used as an integral part of the taxpayer's principal **business** activity.

The only deviation from the statutory definition of business income is contained in subdivision, (c)(4) dealing with dividends. That portion of the regulation provides that dividends are **business** income when dealing in securities is a principal business activity of the taxpayer, and that most other dividends are nonbusiness income. (Compare Cal. Admin. Code, tit. 18, reg. 25120, subds. (c)(1), (c)(2), (c)(3) & (c)(5) (art. 2) with Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(4) (art. 2).) We can discern no rational basis for the regulation's failure to focus on the relationship of the stockholding to the operations of a nondealer's **trade** or business, and respondent has suggested none. The only argument in support of this position which respondent has suggested is couched in terms of pre-UDITPA practice and precedent. We reject this argument for the reasons which we have **previously discussed in parts II and III of this opinion.** To the extent that **subdivision (c)(4)** of regulation 25120 purports to **lay down** a general rule for taxpayers other than dealers in securities, it is neither reasonable nor rational and must be rejected as invalid.

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In a further attempt to salvage regulation 25120, subdivision (c)(4), respondent argues that by virtue of **subsequent statutory** amendment the regulation has the force and effect of statutory law,

The regulation in question was adopted on May 29, 1971, and was effective for income years beginning after December 31, 1966. In 1974 the Legislature adopted the Multistate Tax Compact, the text of which is set forth in section 38006. Article IV of the Compact is UDITPA. At the time the Compact was adopted the Legislature also amended section 25138 to provide that Article IV of the Compact was to be considered a reenactment of the original UDITPA provisions without any inference that a change in interpretation was implied by such enactment. It is respondent's position that by so amending section 25138, the Legislature gave its express approval to the interpretation of section 25120 embodied in regulation 25120, subdivision (c)(4), on the theory that a regulation which is so approved by the Legislature has the force and effect of statutory law. (See Nelson v. Dean, 27 Cal.2d 873 [168 P.2d 16] (1946).)

Respondent's argument must be rejected. The legislative reenactment doctrine can only be invoked where the regulation promulgated by the administrative agency as an interpretation of a statute is reasonably consistent with the statute. As we have held, respondent's interpretation, as reflected in the regulation, is inconsistent with the plain language of section 25120, subdivision (a), and the entire statutory scheme of UDITPA. An erroneous administrative construction does not govern the interpretation of a statute, even though the statute is subsequently reenacted without change. (Witcomb Hotel, Inc. v. Cal. Emp. Corn., 24 Cal.2d 753, 757 [151 P.2d 233] (1944); ct. Hampton Roads Industrial Electronics Corp. v. United States, 178 F.Supp. 474 (Ct. Cl. 1959) where it was held that three years is not a period of time long enough to invoke a presumption of legislative acquiescence.)

For the foregoing reasons, we conclude that the dividends received from Aramco and CPI constitute apportionable business income within the meaning of section 25120, subdivision (a).

V. Mobil, ASARCO and Woolworth

We believe that this decision is also in harmony with the recent pronouncements of the United

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States Supreme Court in Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 [63 L.Ed.2d 5101 (1980)]; ASARCO, Inc. v. Idaho State Tax Commission, -- U.S. -- [73 L.Ed. 2d 787] (1982); and W. Woolworth Co. v. Taxation and Revenue Department, -- U.S. -- [73 L.Ed.2d 819] (1982).)

This trilogy dealt with a state's constitutional power to tax a portion of the dividends received by a nondomiciliary corporation from subsidiaries or affiliates not doing business in the taxing state. In Mobil the Court concluded that the state could constitutionally subject the nondomiciliary corporation's dividend income to an apportioned tax while in ASARCO and Woolworth the Court concluded that the state could not. Since those cases dealt with the constitutional power of a nondomiciliary state to tax, they do not directly control the treatment of the Aramco and CPI dividends because appellant is a California domiciliary; therefore, it is undisputed that California has a legitimate claim to tax some, although perhaps not all, of appellant's intangible income. (See Mobil, supra, 445 U.S. at 445-446.)

Mobil is the central case. (ASARCO, supra, slip opinion at p. 20, n. 22.) In Mobil, the Court observed that "the linchpin of apportionability in the field of state income taxation is the unitary business principle." (Mobil, supra, 445 U.S. at 439.) In accordance with this principle, what the taxpayer must show in order to establish that the dividend income may not be subjected to an apportioned tax, is that the income was earned in the course of activities unrelated to the taxpayer's instate business operations. (*Id.*) However, Mobil made no effort to show that the operations of its subsidiaries and affiliates were distinct in any economic or business sense from its integrated petroleum operations in the taxing state. In the absence of any proof of a discrete business, enterprise, the state was authorized to conclude that the foreign operations were part of Mobil's integrated petroleum operations. (*Id.*) Therefore, Mobil's dividend income constituted income' subject to formula apportionment. Thus, Mobil established that the due process clause does not prevent a state from including foreign source dividend income in the apportionable income of a nondomiciliary corporation so long as the dividend payor's business activities are not unrelated to the taxpayer's instate business

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operations.^{15/} As long as the dividends received 'reflect profits derived from a functionally integrated enterprise, the dividends constitute income to the taxpayer earned in its unitary business. (Id. at 440.)

Mobil, as well as ASARCO, involved dividends received from both affiliates and subsidiaries. In fact, a substantial portion of **the** dividends received by Mobil was derived from Aramco, one of the primary affiliates involved in the present appeal. In reaching its 'ultimate determination, the Mobil Court was well aware of the fact that the taxpayer's affiliates, including Aramco, were not "unitary" subsidiaries in the combined report sense. (Id. at 428, n. 1.) In upholding **the** apportionment of dividends from affiliates where the ownership interest was significantly less than 50 percent, the Court made it clear that ownership and control were not necessarily required by the Constitution.,

Consistently with Mobil, the focus in both ASARCO and Woolworth was on the existence of some type of "unitary business relationship? (ASARCO, slip opinion at p. 18), or "functional integration" (Woolworth, slip opinion at p. 9) between the activities of the dividend payor and those of the recipient rather than on the existence of a unitary business in the combined report sense.^{16/} ASARCO reaffirmed the principle set out in

15/ The Mobil Court stated:

We do not mean to suggest that all dividend income received by corporations operating in interstate commerce is necessarily taxable in each State where that corporation does business. Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business. (Mobil, supra, 445 U.S. at 441-42.) (Emphasis added.)

16/ That the ASARCO Court was not contemplating unity in the traditional combined report sense is further emphasized by the fact that, notwithstanding the unchallenged combination of ASARCO's wholly owned subsidiaries the Court did not reject out of hand the apportionment question which concerned dividend payors, some of which clearly were not part of the **combined** group.

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Mobil that for dividend apportionment purposes, the dividend **payor** must contribute in some meaningful way to the recipient's unitary business enterprise and, in that sense, function as a part of the **taxpayer's** integrated business. (ASARCO, slip opinion at 8, 9.) The Court in ASARCO and Woolworth was looking not for the existence of a unitary subsidiary in the combined reporting sense, but for the existence of some business interrelationship or interdependence, managerial or otherwise, between the taxpayer and its dividend **payor**.

A fundamental aspect of ASARCO and Woolworth is that the **Supreme** Court was dealing with **fact situations** far **different** from the one addressed in Mobil. Regardless of what one might otherwise conclude concerning the interrelationship between the taxpayers and their dividend payors, it **must be** recognized that the taxpayers in those two appeals offered evidence, accepted by the taxing agencies, that the business operations of the taxpayer were in no way integrated with the operations of the dividend payors. **Both opinions** are replete with references to undisputed testimony and trial court findings which influenced the Court's decisions and contrast markedly with the factual underpinnings of both Mobil and this appeal. The dividend paying subsidiaries in ASARCO were found to be "discrete business enterprises" ~~that,~~ in any business or economic sense, had nothing to do with ASARCO's activities in Idaho., (ASARCO, slip opinion at p. 21.) In Woolworth the Court concluded that Woolworth's operations were not "functionally integrated" with its subsidiaries and that there was no "centralization of management" or other "**economies of scale.**" (Woolworth, slip opinion at p. 11.)

Because there was a lack of operational interrelationships between Woolworth and its dividend paying subsidiaries, contrary to the worldwide integrated petroleum operations in Mobil, the Court focused on centralized management and economies of scale as other factors that could establish the necessary interrelationship. Similarly, in ASARCO the Court's consideration of management, control and ownership were only some of the factors taken into account as possible evidence of some type of functional integration between the dividend payor and the taxpayer's business operations. The existence of a unitary subsidiary in the combined report sense was not **considered** as an essential condition of dividend apportionability.

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Another fundamental aspect of AS'ARCO and Woolworth is that the Court rejected the "full apportionment" theory of taxing corporate **income**, which essentially provides that all income received by a corporation is apportionable "business income" because it "adds to the riches" of the owner. In Woolworth, the Court emphasized that the due process limitation cannot be satisfied merely by the fact that the 'nondomiciliary parent derives some economic benefit--as it virtually always will--from its ownership of stock in another corporation." (Woolworth, slip opinion at p. 9.) Similarly, in ASARCO, the Court held that it is not sufficient, for due process purposes, that the income arises from an investment that can "in some sense ... be said to be for purposes related to or contributing to the [corporation's] business." (ASARCO, slip opinion at p. 19.) In rejecting the notion that due process can be satisfied either by the general economic advantages flowing from stock ownership or by the taxpayer's general **corporate** purpose to make money on its stock investments, the Court reiterated the Mobil requirement that there must be some demonstrable integration between the taxpayer and the dividend **payor** in order for a nondomiciliary state to require apportionment of dividend income.

The existence of the same sort of integration is what led us to conclude that appellant's dividends from Aramco and CPI constituted apportionable business income within the terms of **UDITPA's** functional test. In this appeal the fundamental inquiry concerned the relationship between the interests represented by the stockholdings and the shareholder's **unitary** business. For this reason there is no inconsistency between the test applied by the Supreme Court and our application of **UDITPA's** functional test in this appeal.

From the standpoint of **general unitary** theory, it is unfortunate that the three cases failed to distinguish between a "unitary business" and "business income," two related but analytically distinct concepts. Defining the parameters of the "unitary business" involves ascertaining the circumstances under which all corporations engaged in a single integrated economic enterprise may be permitted or required to file a combined report. The concept of "business income," on the other hand, generally concerns the differentiation between truly passive investment income and income which is integrally related to the taxpayer's unitary business activities. Merely because the operations and management of a corporation in which the taxpayer is a stockholder are not so closely

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connected with the taxpayer's business activities as to be part of the taxpayer's "unitary business" for combined reporting purposes should not mean that dividends received from the stock cannot be **"income** arising from transactions and activities in the regular course of the taxpayer's trade or business" or that the **"acquisition, management, and disposition"** of the stock do not "constitute integral parts of the taxpayer's regular trade or business operations." The criteria for combined reporting purposes and the definition of business income **serve** different **purposes, ask** different questions and apply different standards. The resolution of one does not compel the same resolution of the other.

Whatever uncertainties may remain after the Supreme Court's decisions, there is little doubt that it **would be constitutionally** permissible for a **nondomiciliary** state to tax an apportioned share of appellant's dividends from Aramco and CPI. On the basis of the factual record appellant has made in this case, we do not believe that it would be seriously tempted to argue in other states that these dividends were "earned in the course of activities unrelated to" the conduct of its unitary petroleum business in those states, or that the operations of Aramco and CPI were "distinct in any business or economic sense" from the rest of appellant's unitary business so as to constitute "discrete business **enterprise[s]."** (See Mobil, slip opinion at p. 13.) Under these circumstances, we are compelled to conclude not only that the apportionment of these dividends is proper as a matter of California law, but also that any other result would be fundamentally unfair to appellant because of the overwhelming probability that this same income is rightfully **subject** to an apportioned tax in all the other states in which it conducts its unitary business.

For the reasons discussed above, respondent's action in classifying the Aramco and CPI dividends. **as** nonbusiness income and specifically allocating them to appellant's commercial domicile in California must be reversed.

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ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on-the protest of Standard Oil Company of California against a **proposed** assessment of additional franchise tax in the amount of **\$4,867,453.93** for the income year 1967, be and the same is hereby reversed with respect to the treatment of the Aramco and CPI dividends, and insofar as it determined that all other dividends paid by corporations not included in the combined report constitute **specifically** allocable nonbusiness income as a matter of law.

Done at Sacramento, California, this 2nd day
Of March, 1983, by the State Board of Equalization, with
Board Members **Mr. Bennett**, Mr. Dronenburg, Mr. **Collis**,
Mr. Nevins, and Mr. Harvey* present, Mr. Collis **abstain-**
ing because of his inability to attend the oral hearings,
Mr. Nevins abstaining because of a conflict of interest,
and Mr. Harvey* voting NO.

William M. Bennett, Chairman
Ernest J. Dronenburg, Jr., Member
_____, Member
_____, Member
_____, Member

*Acting in place of Mr. Cory, Controller, pursuant to section 7.9 of the Government Code.